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SUBJECT: AN ECONOMIC ASSESSMENT OF DUARTE'S TENURE

¶1. (U) SUMMARY: President Duarte,s 2003-2007 economic performance yielded mixed results. Macroeconomic stability was achieved but a rigid expenditure structure, a visible bias to support current expenses instead of public investments, and a political rather than an economic spending rationale undermined the economic impact of stability. Public sector reforms significantly improved revenue collections but failed to address, among other issues, the lack of predictability in the judicial system and the inefficiency of state-owned companies. Paraguay registered impressive economic growth rates but most of the growth is attributed to exogenous factors (good weather, high commodity prices, and increasing remittances). The country,s competitiveness declined, unemployment increased and, extreme poverty levels deteriorated. The next (August 2008) government will have to deal with these challenges, but it does not need to reinvent the wheel. It will need an economic policy framework that is independent of specific interests, provides incentives to improve the business environment, promotes private sector growth (especially for small and medium size enterprises) and maintains macro economic stability. END SUMMARY

¶2. (U) President Nicanor Duarte Futros, 2003-2008 economic plan identified most of the country,s economic challenges but had mixed results in the execution. Key challenges recognized included: a small, open economy vulnerable to external shocks (high oil prices) and exogenous factors (international commodity prices, weather conditions); a rapidly growing population coupled with urban migration and intellectual immigration; high levels of income inequalities and poverty; a non-competitive economy with incipient industrial capacity; sluggish growth rates compared to the region; high levels of unemployment and sub-employment where informal small and medium enterprises (SMEs) comprised most of the economy activity; a weak financial system; limited tax revenue collections; poor infrastructure for essential services (communications, electricity, water) and commercial activity (roads, rail lines, river ports); and, a labor market that is mostly uneducated and lacks training. (NOTE: The economic plan failed to mention state-owned companies and a weak judicial system as key factors sinking Paraguay,s competitiveness. END NOTE). Duarte,s economic plan addressed these challenges in a policy agenda that focused on macroeconomic stability, structural reforms, economic growth, and poverty reduction. These themes have defined the economic hits and misses of Duarte,s tenure thus far.

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MACROECONOMIC STABILITY -- IS IT THE BIGGEST HIT?  
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¶3. (U) In general terms, Duarte,s administration achieved macroeconomic stability (NOTE: Consensus among local economists is that Duarte,s hands-off approach--minimal political interference in his cabinet,s economic policies--largely contributed to results. END NOTE). From

2003 to 2007, the government exercised fiscal discipline and fiscal expenditure increases were offset by higher revenue collections. From a fiscal deficit of 3.2 percent of GDP in 2002, the country moved to a surplus of 0.5 percent of GDP in 2007. Though prices experienced upward pressure and several inflationary swings during 2007, effective Central Bank interventions controlled and brought down inflation to targets at an average annual rate of 6.0 percent. As an indicator of financial sector stability, total bank deposits doubled to USD 3.5 billion from 2003 to 2007 with a 10.5 percent increase in Guarani deposits during the same period. International reserves almost tripled from USD 983 million in 2003 to over USD 2.3 billion in 2007. External debt declined 11.2 percent from 2003 to 2.1 billion USD in 2007 and, the country's long-term sovereign debt risk rating, as reported by S&P, improved from B- to B. Paraguay renewed May 2006 its Stand-by Agreement with the International Monetary Fund (IMF) and received a very positive review and outlook on the IMF's October 2007 revision.

14. (U) Undermining the economic impact of the achieved macroeconomic stability is the administration's rigid expenditure structure, its evident bias to make larger increments in current expenses instead of capital investments, and its incapacity to adequately prioritize investments based on economic returns. From 2003 to 2007, the annual distribution of expenditures remained roughly 83 percent for current expenses (around 70 percent is directly or indirectly related to personnel expenses) and 17 percent for capital investments. For the first 10 months of 2007, the 18.3 percent increase in current expenses (mostly for government jobs) was three times higher than the accompanying 6.2 percent increase in public investments. For public investments there is no real cost-benefit analysis. Though always framed within a tight fiscal framework, priorities often follow a political more than an economic return. Out of 64,310 km only 4,234 km of roads were paved during 2003-2006; and, electricity shortages in a hydro-power rich country are two examples of under-investment.

15. (U) The 2008 budget had a USD 300 million increase (10.7 percent), from USD 2.6 billion to USD 2.9 billion. According to Minister of Finance Barreto, the increase had no clear financing sources and pushed the fiscal surplus into a deficit. Barreto gained approval January 2008 to cut roughly USD 200 million. (NOTE: With this budget cut the government appears serious in its intent to maintain fiscal discipline. The cut, however, is counter-intuitive. Most of the increments were planned for government salaries and benefits. With elections this year, there are growing fiscal pressures, through increments in current fiscal spending, to use the government's political patronage and get votes. It is early to see if the cuts will hold. The budget is due for revision and adjustment May 2008. END NOTE).

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STRUCTURAL REFORMS - MORE MISSES THAN HITS  
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16. (U) Perhaps the most important achievement of Duarte's structural reforms was the tax reform which simplified the code, expanded the taxpayer base, and increased revenues. From USD 582 million in 2003 to USD 1.4 billion in 2007 tax revenues increased 145 percent. The number of taxpayers increased 54 percent from 278,290 in 2003 to 429,851 in 2007. Another public sector reform with modest results was the reduction of illegally registered people in the pension system. From 2003 to 2007, 14,700 illegally registered individuals were removed from the pension system, saving the government USD 47 million. The government missed the other two public reform targets -- improving the quality of fiscal expenditures and rationalizing the number of government employees. The quality of fiscal expenditures, measured as how expenses are allocated, deteriorated. The number of government employees increased more than 15 percent from 2003 to 2007. (NOTE: Another public sector item in dire need of reform but not addressed is the institutionalization of the civil service. Most government jobs are still based on

political affiliation. END NOTE). Other reforms to improve the business environment and promote private sector growth yielded modest results: bank regulations and supervision were strengthened; the number of procedures to export and register new business was simplified; and, a new fund, Financial Development Agency (AFD), facilitated the expansion of credit to SMEs and low income housing through risk sharing guarantees with commercial banks.

¶17. (U) The structural reforms excluded reforms to improve the predictability and transparency of the judicial system and failed to address the inefficiency of state-owned companies. Paraguay,s judicial system is characterized by a lack of independence and corruption. Efforts are needed to strengthen the rule of law and make the judicial process more transparent, unbiased and fair. Corruption, patronage and bias are pervasive features of the current judicial system. With regard to state-owned enterprises, powerful interest groups oppose the attempts to privatize and reduce the role of the government. Large state-owned companies (rail, petroleum, cement, electricity, water, and basic and long distance telephone services) employ thousands of potential voters and are outlets for political patronage.

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ECONOMIC GROWTH UP - COMPETITIVENESS DOWN  
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¶18. (U) Though 2007,s impressive 6.4 percent GDP growth rate to USD 12.8 billion is Paraguay,s highest in over 20 years, growth is tied and highly vulnerable to exogenous factors. Growing world demand for commodities combined with high prices and favorable weather to support Paraguay,s commodity-based export expansion. Agriculture production drove 66 percent of 2007 GDP growth rate. Soy and soy-related products (54.1 percent), cereals (11.6 percent) and meat (10.9 percent), represent 76.7 percent of 2007 USD 3.3 billion registered exports. On the external side, a high internal consumption fueled by current expenditures and remittances (over USD 250 million in 2007 according to the Central Bank of Paraguay) also significantly contributed to the GDP growth rate. (NOTE: An Inter-American Development Bank,s study estimated Paraguay,s 2006 remittances at USD 650 million. Local economists 2007 estimates are at USD 800 million or around 6 percent of GDP. END NOTE).

¶19. (U) Mechanized agriculture production increased cultivated land area and yields per hectare. In 2007 the yields for soy increased 56 percent reaching 2.68 kilogram per hectare and production totaled 6.5 million tons, 71 percent more than ¶2006. For 2008 the commodity export market outlook is positive. Soy production fields expanded 10 percent and, while it is early in the cycle, there have been adequate rain levels. Farmers are already selling soy production for shipment in May 2008 at an average of USD 270 per ton (farm gate prices). Similarly, meat prices are at sustained high levels for key export markets (USD 3,500 per ton for Chile and USD 2,214 per ton in Russia) and, the expectation is that growing global demand will continue to drive prices up.

¶10. (U) According to the World Economic Forum 2007 Global Competitiveness Index (GCI), Paraguay has one of the least competitive economies in the world. It ranks 121 out of 131 countries. Only Guyana (126) ranks lower in Latin America. Except for macroeconomic stability, Paraguay,s competitiveness is undermined by poor infrastructure, low institutional capacity, scarce trained labor, limited predictability in the regulatory and legal framework, and market distortions from state-owned enterprises in the supply of essential services (electricity and communications).

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NOT EVERYONE IS A WINNER  
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¶11. (U) Income inequalities, extreme poverty, and unemployment marked Paraguay,s 2003 to 2007 growth. The percentage of people living in poverty increased to 42

percent in 2006 from 38.2 percent in 2005, with extreme poverty growing from 15.5 percent to 21 percent. Most of Paraguay,s growth benefited the capital intensive agribusiness and pushed migration of unemployed rural workers to urban centers. Mechanized agricultural production supported the commodity export expansion but did not generate jobs. Labor intensive crops such as cotton experienced production volume declines of 55.1 percent in 2007. Total unemployment (open plus hidden unemployment) increased from 9.4 percent in 2005 to 11.3 percent in 2006 and, under-employment reached 24 percent in 2006. 58 percent of 5.9 million Paraguayan reside in urban areas, mainly Asuncion. The expansion of mechanized agribusiness will continue to displace workers. (NOTE: The next government needs to accompany this production shift with policies to encourage the growth of SMEs, especially along the agro value chain. Though there are incentives to promote "maquilas", Paraguay lacks a coherent policy to encourage and sustain investment projects of labor intensive manufacturing industries. END NOTE).

12.(U) COMMENT: Overall, the economic performance of Duarte,s 2003-2007 tenure is below average and the next government will have to deal with conditions similar to those in existence when Duarte took office in 2003. The benefits of Paraguay,s macroeconomic stability and explosive growth did not reach the majority of the population. Powerful interests groups continue to reap most of the gains. As unemployment and sub-employment raises more people leave the country, a disfranchised feeling, amid all the talks of economic growth, exists and, the perceived lack of economic opportunities pervades the economy. Sustained growth largely depends on macroeconomic stability and the next government does not need to reinvent the wheel. It will need, however, an economic policy framework that is independent of specific interests, prioritizes economic infrastructure, improves the judicial system, attracts foreign investment, privatizes state-owned enterprises, promotes private sector growth (especially SMEs) and maintains the achieved macroeconomic stability.

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